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Hybrid Horizons: Hybrid Capital as a Tool in Out-of-Court Debt Workouts

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For many sponsor-backed and other highly leveraged private companies, the disruption of the pandemic, the current interest rate environment and the tariff regime have each created challenges. As borrowers and lenders consider options on how best to address pending or anticipated defaults, hybrid capital instruments will, and should, be considered versatile tools in the toolbox.

Hybrid capital instruments can take different forms but are generally equity (or equity-like) instruments filling gaps between traditional equity and debt positions on a balance sheet. Whether it is issued as consideration for covenant holidays or other accommodations, a means of right-sizing balance sheets through debt for equity swaps or a method of "handing the keys" to a lender group, hybrid capital can be structured to accomplish the parties' goals.

Consideration for Lender Accommodation

At one end of the spectrum, hybrid capital can provide a non-cash, tax-efficient form of consideration to lenders agreeing to a financial covenant holiday, covenant relief to allow access to additional financing or extension of maturity. This often takes the form of warrants or preferred equity (or a combination of the two) intended to allow the lender to share in the "upside" made possible by the lender accommodation. While we typically would expect the inclusion of customary protections to ensure the value of the new, hybrid security is not impaired or disproportionately modified, the hybrid instrument can be structured so that it does not interfere with the existing governance of the issuer to the extent important to the existing equity sponsor.

Debt for Equity Swap to Right-Size the Balance Sheet

Where a long-term impairment of the business has resulted in excess financial leverage, structured preferred equity can be used to right-size the balance sheet and still retain the lender's relative return priority over the sponsor or other equity owners. This often takes the form of "debt-like" preferred equity plus warrants or other equity "kickers." The terms for these instruments are unique to each transaction but often include a preferred equity instrument with economic and covenant protection in line with the debt for which it is exchanged. Hybrid capital structured as equity is not debt and does not carry with it the panoply of lender remedies, and care must be taken to ensure the securities provide appropriate economics and protections for the lender-equity holder while at the same time accomplishing the balance sheet de-levering sought by the borrower.

Hybrid Capital to Cede Control

In situations where the parties agree that the lender holds the fulcrum security and effectively owns (or will own, upon completion of a capitalization) the borrower, hybrid capital can be used to accomplish the handover, provide economic preference to the lender and allow existing equity holders to maintain a subordinated stake in the borrower. It can be structured to provide complete control in favor of the exchanging lender, can contemplate independent director control and even can provide for continued governance for the pre-handover equity. Similarly, economics can be structured as the parties agree, including waterfalls that provide pre-handover equity with a greater share of economics as the lender's returns increase. Lastly, this can be done as part of a balance sheet right-sizing, with economics and governance rights toggling in favor of the lender upon agreed-upon defaults or milestone failures.

Hybrid Capital as Third-Party Financing

As we have explored in our previous posts, hybrid capital is an increasingly common type of financing for buyouts, dividend recapitalizations and refinancings. It is also a useful form of rescue financing. Numerous funds formed or designed to invest in hybrid capital or special situations, as well as sovereign wealth funds, insurance companies, family offices and private credit funds are eager participants in this market. Financing by these types of third parties may be available as rescue financing to deleverage the balance sheet or provide needed liquidity. These transactions can provide additional equity capital for the borrower, benefiting existing lenders, while providing less dilution and governance control than traditional equity investments, benefiting the borrower and its incumbent owners.

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